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Abstract

This paper evaluates the primary legal and financial mechanisms that help support the development of a venture capital market. Specifically, we argue that emulating the organization and contractual pattern of the US venture capital market could enhance the development of the European venture capital market. We first show that the modernization of the 'venerable' limited partnership form, based on US experiences, offers substantial contracting benefits for investors and is crucial to the operation of a mature venture capital market. We then argue that the emergence of more efficient limited partnership structures can emerge from jurisdictional competition between European states. We argue that the United Kingdom, which has recently embarked on general and limited partnership law reform, could, in light of the competitive lawmaking environment that the ECJ has opened up, be in the best position to enter the competition within the EU. It then explores the prominent features of the UK special Limited Partnership statute, which makes it possible for venture capitalists to organize their contractual relations that are best suited to the characteristics of the venture capital market. Finally, our analysis provides an understanding of the competitive forces that shape legal change, which has implications for the ongoing debate in the Europe over the reform of limited partnership law and related business forms.

Keywords: Venture capital, innovative companies, limited partnerships, public policy.

1. INTRODUCTION

This article considers the circumstances under which responsive lawmakers will adopt governance mechanisms that could facilitate the development of a broader venture capital market in Europe. It is thought that should conditions emerge for lawmakers to act proactively, some will inevitably look to the differences between the United States and European venture capital environments so as to determine which legal rules and institutions might be worth replicating. Whilst the lack of an entrepreneurial mindset partly explains the differences, there are of course other economic factors that may contribute to the difference in the relative performance of the two markets.[1] The European venture capital market is constrained by regulatory hurdles that limit early-stage investment, and capital market structures that restrict the ability of venture capital funds to liquidate their positions in innovative start-ups. In this setting, a fundamental problem for Europe remains how to stimulate the development of efficient institutional arrangements that encourage investors and venture capitalists to actually invest in start-up firms and create a steady supply of entrepreneurs and the necessary finance to drive entrepreneurial firms.[2]

Much of the literature on private equity shows that the internal governance structure of venture capital funds often plays a crucial role in financing start-up firms. Accordingly, if governance structures are effective in limiting opportunism and controlling the level of risk, investors are more likely to contribute capital to start-up firms through venture capital funds. Legal business forms that supply parties with flexible default rules to align the interests of investors and venture capitalists are an appropriate solution to contractual incompleteness. The attention to the contractual and organizational structure of venture capital funds may increase now that it is widely accepted that the private equity market is prone to violent cyclical movements.[3] Indeed, jitters in the financial market and the prolonged economic downturn have altered the players' attitude and re-enforced the importance of the role of governance and organizational structures for economic performance.

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[1] Cf. J. Bankman and R.J. Gilson, 'Why Start-ups?', 51 *Stanford Law Review* (1999) p. 51.

[2] See B. Black and R.J. Gilson, 'Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets', 47 *Journal of Financial Economics* (1997) pp. 243-277; R.J. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function', 49 *American Journal of Comparative Law* (2001) pp. 329-358; C. Keuschnigg and S.B. Nielsen, *Start-ups, Venture Capitalists, and the Capital gains Tax*, Center for Economic Studies & Ifo Institute for Economic Research (CESifo) Working Paper No. 742 (2002); E.B. Rock, 'Greenhorns, Yankees and Cosmopolitans: Venture Capital, IPOs, Foreign Firm & U.S. Markets', 2 *Theoretical Inquiries in Law* (2001) pp 711-744.

[3] Cf. W.W. Bratton, 'Venture Capital on the Downside: Preferred Stock and Corporate Control', 100 *Michigan Law Review* (2002) pp. 891-945.

Given the claims about the importance of organizational and legal structures and institutions for the growth of start-ups, it is clear that some business forms prove more successful in the long term. In the United States, there is a growing volume of empirical studies on the relationship between the legal structures and institutions and firm performance. Advocates explain that if Europe were to replicate the US market, it should give priority to establishing high labour mobility and risk tolerance,[4] a well-developed stock market,[5] and large, independent sources of venture capital funding.[6] In order to achieve this objective, policymakers across Europe attempt to increase the supply and demand of venture capital by giving subsidies in the form of tax breaks,[7] but largely ignore the role of business organization law. Recent research, however, shows that government support should be carefully weighed against possible negative effects on the venture capital market. First, government sponsorship could crowd out the supply of venture capital, if it does not encourage all the players in the venture capital industry. For instance, a tax incentive to encourage individual investors to pour money into a special venture capital fund vehicle could reduce the supply of other, relatively more informed venture capital investments.[8] Second, policy measures that lower the cost of entry and hence attract more entrepreneurial start-ups could cut back venture capitalists' managerial

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[4] American executives and research personnel often resign to join new ventures. Americans have an inborn tolerance of risk, whereas Europeans are generally more risk-averse. In addition, failure is not something to be ashamed of in the United States; on the contrary, failure is appreciated nearly as much as success. See C.J. Milhaupt, 'The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate', 91 *Northwestern University Law Review* (1997) pp. 865-898.

[5] See Black and Gilson, *supra* footnote 2. They argue that a well-developed stock market that allows venture capitalists to exit through an initial public offering (IPO) is critical to the existence of a vibrant venture capital market.

[6] See Milhaupt, *supra* footnote 4. Empirical research shows that independent venture capital firms are willing to make early-stage investments. In the United States, most venture capital firms are independent private partnerships, whereas in Europe most tend to be affiliated to banks, pension funds, corporations and insurance firms.

[7] See, e.g., Keuschnigg and Nielsen, *supra* footnote 2.

[8] See D.J. Cumming and J.G. MacIntosh, *Crowding Out Private Equity: Canadian Evidence*, Working Paper (2002).

support, thereby increasing the risk of start-up activities.[9] Consequently, it might be argued that in a start-up-friendly environment the entrepreneurial success rate could decrease.[10]

Despite these arguments, this article asserts that flexible business forms must play a central role in the development of a robust venture capital industry across Europe. If there is a trade-off between the cost of entry and the success rate of business start-ups backed by venture capital, it seems more important to cut back on government sponsored programmes and stimulate business law reform, which benefits entrepreneurs, venture capitalists and outside investors alike. The supply of a venture capital-friendly business form could help to mitigate the moral hazard problems. Not only should the business form statute facilitate privately negotiated venture capital contracts, but it should also provide efficient guidance to both the parties and courts in the event of an incomplete contract. Our analysis suggests that, in an increasingly competitive environment, European countries will arguably be better off by improving the infrastructure in which a venture capital market can develop and offering clear-cut advantages than by pursuing a one-sided stimulation programme.

One of the central features of the venture capital governance environment is the limited partnership structure. This business form provides the underpinning of most venture capital funds, allowing venture capitalists and investors to create contractual terms that are consistent with their respective economic objectives. Effectively, the

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[9] See Keuschnigg and Nielsen *supra* footnote 2.

[10] Cf. B. Cassiman and M. Ueda, *Optimal Project Rejection and New Firm Start-Ups*, Centre for Economic Policy Research (CEPR) Discussion Paper No. 3429 (2002) (arguing that reducing the cost of entry does not always increase the start-up rate when it leads incumbent and established firms to reduce their research and development expenditures): 'Contrary to common belief, we find that the development of venture capital markets and stock markets, or subsidies towards new firms do not always increase the start-up rate. This happens when the cannibalization effect is strong. When a start-up becomes less costly, the established firm expects that rejecting projects is more likely to lead to the start-up of competing firms. Because of this negative externality, the established firm reduces the R&D expenditures and consequently less ideas will be generated.'

limited partnership structure permits venture capitalists to achieve extensive control over the operation of their venture capital funds subject to few intrusive legal obligations. In the United Kingdom, the limited partnership structure has enjoyed an upsurge of popularity since venture capital funds were allowed to employ limited partnerships in 1987. Whilst the UK limited partnership structure has become popular with venture capitalists across Europe, the United Kingdom risks losing its leading position to other jurisdictions that have introduced or planned to design new legislation comparable to the provisions available under Delaware law. One of the purposes of this paper is to discuss the impact of regulatory competition in leading states to provide limited partnership structures that are more flexible. To illustrate some of the implications of this approach, we discuss in greater detail in Sections 5 and 6 below, the changes that have been introduced into the UK limited partnership law structure, which has been made more adaptable to the needs of business.

The remainder of the paper is organized as follows. Section 2 examines whether 'piggybacking' on US legal rules and institutions is conducive to the development of a mature venture capital industry within Europe. It is submitted that, despite its widespread use, piggybacking might straitjacket the development of a robust European venture capital market. This article will suggest that the modernization of the venerable limited partnership form is crucial to Europe's attempt to emulate the successful US venture capital market.

Section 3 will explain why the limited partnership form is used predominantly in the US and European venture capital industry. More importantly, it will examine how this business form allows the internal and external participants to reduce opportunism and agency costs. The analysis will determine which organizational and contractual features of the limited partnership make it attractive for venture capital investing. This analysis builds on and extends the empirical studies that have already been carried out in the United States.[11]

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[11] See A. Admati and P. Pfeiderer, 'Robust Financial Contracting and the Role of Venture Capitalists', 49 *Journal of Finance* (1994) pp. 371-402; M. Baker and P.A. Gompers, *The Determinants of Board Structure and Function in Entrepreneurial Firms*,

Viewed in this context, an examination of the competition-induced development of the limited partnership form would appear to offer essential lessons for Europe as it embarks on business organizational law reform in general. Section 4 analyzes the various institutional structures in Europe that give rise to competitive lawmaking in the field of partnership-type business forms. Indeed, recent decisions of the European Court of Justice in *Centros, Überseering* and *Inspire Art* could trigger the development of competitive lawmaking in Europe, which could give member states incentives to adopt, for example, new limited partnership statutes that are in line with the requirements of venture capital investors. [12]

In section 5 we identify how the United Kingdom stands to benefit from meeting the needs of businesses by supplying them with a full range of value enhancing business forms. This section focuses on the factors that recently led the United Kingdom to modernize the limited partnership laws.

Working Paper (2000); J. Bankman, 'The Structure of Silicon Valley Start-ups', 41 *UCLA Law Review* 41 (1994) pp. 1737-1768; Barry, et al., 'The Role of Venture Capital in the Creation of Public Companies', 27 *Journal of Financial Economics* (1990) pp. 447-471; P.A. Gompers, 'Optimal Investment, Monitoring, and the Staging of Venture Capital', 50 *Journal of Finance* (1995) pp. 1461-1489; M. Gorman and W.A. Sahlman, 'What Do Venture Capitalists Do?', 4 *Journal of Business Venturing* (1989) pp. 231-248; Th. Hellmann, 'The allocation of control rights in venture capital contracts', 29 *RAND Journal of Economics* (1998) pp. 57-76; L.A. Jeng and P.A. Wells, 'The Determinants of Venture Capital Funding: Evidence Across Countries', 6 *Journal of Corporate Finance* (2000) pp. 241-289; S.N. Kaplan and P. Stromberg, *Financial Contracting Theory Meets The Real World: An Empirical Analysis of Venture Capital Contracts*, National Bureau of Economic Research (NBER) Working Paper 7660 (2000); J. Lerner, 'Venture Capitalists and the Oversight of Private Firms', 50 *Journal of Finance* (1995) pp. 301-318; W.A. Sahlman (1990), 'The Structure and Governance of Venture-capital Organizations', 27 *Journal of Financial Economics* (1990) pp. 473-521.

[12] Case C-212/97, *Centros Ltd.* v. *Erthvers-og Selskabbsstyrelsen*, [1999] *ECR* I-1459, [1999] 2 *CMLR* 551 (*Centros*); Case C-208/00, *Überseering BV* v. *Nordic Construction Company Baumanagement GmbH (NCC)*, [2002] *ECR* I-9919 (*Überseering*); and Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam* v. *Inspire Art Ltd (NL)*, [2003] *ECR* 1 (*Inspire Art*). These decisions are available at <http://europa.eu.int/cj/en/content/juris/index.htm> (last visited 24 February 2004).

Section 6 evaluate the implications of creating a separate, free-standing limited partnership form, such as the UK special limited partnership, that allows investors and venture capitalists greater flexibility and procedures, thereby reducing their transaction costs. Such a vehicle may promote new forms of investment, in that potential innovative entrepreneurs and new participants in venture capital investing could more easily translate their ambitions into reality. The commitment to introducing a new business form could, moreover, stimulate high-profile, sceptical domestic and foreign venture capitalists to invest in new firms. The prospects for the introduction of a new vehicle depend on a variety of factors, including competitive market pressures. We posit, moreover, that the competition between lawmakers could overcome the path dependent barriers to the introduction of a suitably designed vehicle. This seems to be particularly true for the business forms and contractual mechanisms that are employed at the level of both the venture capital funds and the portfolio firms into which venture capitalists pour their money. Section 7 concludes.

2. THE NEED FOR A GENUINE EUROPEAN VENTURE CAPITAL MARKET

In this Part, we focus on the main legal and organizational elements that are required to support the development of a successful venture capital market in Europe. At present, it is widely assumed that, despite the venture capital market's wave of growth in the late 1990s, the European market continues to lag considerably behind the United States.[13] For the European market to mature so as to support further phases of economic growth and development, policymakers should focus on overcoming the institutional, legal, fiscal and cultural obstacles that impose significant costs on firms and investors. As far as the institutional and legal obstacles are concerned, we can identify a large variety of rules

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[13] See A. McCallum, 'Key Developments at the Heart of the European Union', 14 *EuroWatch* (2002) p. 5 (arguing that despite sustaining an even steeper decline, the United States still raised three times more venture capital than the European Union in 2001).

that create disincentives for potential entrepreneurs to innovate and for risk-averse investors and venture capital funds to make early-stage investments. In a competitive lawmaking environment, it is only to be expected that some jurisdictions within Europe will continue to adjust their business form and securities regulations to satisfy the preferences of entrepreneurs and suppliers of capital.

Yet commentators suggest that in order to overcome these barriers, entrepreneurs and venture capitalists should attempt to be as 'American' as possible, preferably by relocating to and incorporating in the United States.[14] They argue that start-up firms can piggyback on US capital market institutions and their securities regulations, including venture capital investors.[15] Some scholars emphasize that the presence of an IPO is perhaps the most significant factor explaining the existence of a robust venture capital market. The importance of the IPOs relates to the willingness of venture capitalists to invest more money when there is security to withdraw funds from an enterprise at a specific date. The focus on the exit mechanism is crucial to venture capitalists, not so much because of the purported virtuous link between venture capital and a national capital market, but because of the availability of different efficiency-enhancing mechanisms that allow exit.

The importance of a national stock market for the growth of a venture capital market has already been questioned by scholars, who have noted that over the last decade venture capitalists and entrepreneurs have been able to entirely bypass their local exchange when exiting the firm or rely on trade sales.[16] Evidence from Israel's IT sector, for example, suggests that foreign firms may be able to piggyback on another jurisdiction's

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[14] See Rock, *supra* footnote 2. But see E.B. Rock, *Coming to America? Venture Capital, Corporate Identity and U.S. Securities Law*, University of Pennsylvania Law School, Institute for Law and Economics Research Paper No. 02-07 (arguing that despite the fact that Delaware markets Delaware incorporation all over the world, US securities law allows and invites foreign firms to present themselves as Americans without incorporating in the United States).

[15] See Black and Gilson, *supra* footnote 2.

[16] Venture capitalists consider trade sales as the most important exit vehicle for venture capital finance. In fact, for many markets, IPOs are the least probable exit strategy for venture capitalists. Cf. Cumming and MacIntosh, *supra* footnote 8.

institutions, making it possible to grow a domestic venture capital industry at low cost.[17] One way to address the absence of a mature capital market is for start-up firms to publicly trade shares on a foreign exchange. The increasing reliance on foreign regimes to supply the full range of regulatory protections that investors prefer could explain the greater distribution of firms listing in the United States and the impressive development of Israel's venture capital market in the late 1990s. It may be, as Rock argues, that foreign IT firms really have the option of becoming US firms. Yet there may be little reason to think that most of these firms, given their presence in the United States, are actually anything more then US firm. The level of institutional investor holdings and industry-wide support tends to confirm the view that these firms operate and report as if they are US corporations. In this respect, contrary to Rock's assertion, there may be little freedom for Israeli entrepreneurs to choose their identity. Indeed, the piggyback hypothesis has been a plausible scenario in the capital markets of the 1990s, which were heavily influenced by sophisticated US institutional investors and financial intermediaries.

In contrast, European venture capital players tend to work within the institutions and legal regimes that are currently available across the European Union. Piggybacking is not terribly promising for European venture capitalists, since most rely on trade sales as a means of exit. Policymakers in Brussels argue that it is of 'major strategic importance' for the European Union to develop 'its own financial and entrepreneurial capacity to develop its own innovative ideas through new technology companies inside Europe'.[18] It is asserted that piggybacking cannot supply the most fundamental ingredient, which is the presence of ambitious entrepreneurs and investors willing to undertake the necessary

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[17] See Rock, *supra* footnote 2.

[18] See European Commission, *Risk Capital: A Key to Job Creation in the European Union*, p. 7 ('[m]any good European ideas – themselves the result of expensive public investments in education and research – end up being developed in the United States where capital, know-how and the business environment are more conducive to their development and success. It means the migration and loss of some of Europe's best talent and best ideas.').

risks to create value.[19] The need to immigrate to the United States is not conducive to an entrepreneurial mindset. High transaction costs, due in part to unfamiliarity with the institutional, legal, fiscal and cultural infrastructure, may deter potential European entrepreneurs and investors with low risk-tolerance from operating as or investing in a US business.[20]

In practice, both entrepreneurs and European venture capital funds are loath to piggyback on the US market. They tend to invest and divest increasingly in their home countries, relying often on their 'sub-optimal' domestic institutions and legal regimes.[21] Venture capitalists are prone to avoid risks that result from the uncertainty of unfamiliar foreign regulations. In addition, the recent decline in the IPO markets worldwide makes it less attractive for firms to seek such a solution.

The empirical evidence shows that in the past, many European firms, under pressure to 'act American', have adopted US practices, leading to an eventual listing on a US exchange.[22] However, the 1990s boom of entrepreneurs in Europe, inspired by the overwhelming success stories of American high-tech firms, suggests that the current set of European

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[19] Although Gilson suggests piggybacking, he is aware that entrepreneurs are the most important factor. See Gilson, *supra* footnote 2.

[20] Different Rock, *supra* footnote 2: 'The decision to incorporate in the U.S., or to set up a corporate headquarters in the Valley, or to seek investments from prominent Silicon Valley venture capitalists, may be important not so much in and of themselves, but because they teach the entrepreneurs what it takes to succeed and they signal to investors that this is a company that understands what it takes to succeed today.'

[21] See Jeng and Wells, *supra* footnote 11. See also the European Commission, *supra* footnote 18 ('there is also evidence of strong regional fragmentation in the EU as well, with an overemphasis on 'domestic' equity placements.'). To be sure, data shows that European firms have listed on the NASDAQ as means of exit.

[22] See J.C. Coffee jr., 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications', 93 *Northwestern University Law Review* (1999) pp. 673-674 ('[t]he accelerating pace of this migration may seem surprising when one realizes that foreign issuers incur extensive regulatory costs when they enter the U.S. markets and that most have never thereafter made securities offerings in the United States. Why then do they list? Arguably, companies in smaller markets gain liquidity and possibly also some international recognition and prestige from a U.S. listing. But greater motivation probably lies in the finding, repeatedly observed by financial economists, that the announcement of a dual listing on a US exchange by a foreign firm typically increases the firm's share value.').

institutions (many of which are not identical to US institutions) will eventually be able to bridge the gap between Europe and the United States. While the success of some European start-ups in the late 1990s can be attributed to their choice of adopting US-style legal rules and listing on the US technology exchange, this does not mean that the European entrepreneurial environment need not to make adjustments in the face of declining competition from US markets. European policymakers continue to concede that the creation of an entrepreneurial environment is a necessary prerequisite to stimulate the 'American' mindset and entrepreneurial culture in Europe. To be sure, the success of the venture capital experienced a climax during the bubble years of the late 1990s when they succeeded in turning innovative ideas rapidly into gold. However, the fact that the venture capital industry has undergone a profound change over the past few years, in that venture capital funds have lost most of the millions of dollars invested in high-technology, does not mean that these funds went out of fashion. In practice, with bank credit becoming harder to come by, venture capital funds are still the only funding source for start-ups. The adaptability of these funds is a necessary quality in an ever-changing business environment.

It might be argued that, unlike piggybacking, emulating US techniques could enhance the realization of the much-coveted entrepreneurial environment. This process could gain momentum, since the US institutional investors are shifting into Europe.[23] Over the past few years, overseas venture capital funds seeking to invest in European firms have established offices across Europe. As a result, considerable pressure on path-dependent barriers in the European market may be exerted, as US venture capitalists and investors (including their lawyers and advisors) convey the 'American way' to European players.[24]

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[23] See J.A. Adler and F. Monod, 'American Investors Participating in European Venture Capital Funds', 14 *EuroWatch* (2002) (noting that US investors are increasingly being invited to participate in European Venture Capital Funds).
[24] Cf. G. Hertig, 'Western Europe's Corporate Governance Dilemma', in T. Baums, K.J. Hopt, and N. Horn, *Corporations, Capital Markets and Business in the Law*, Liber Amicorum Richard M. Buxbaum (London, Kluwer Law International) pp. 265-282.

In this context, business forms that make it possible to emulate the most efficient US venture capital contracts may well attract sceptical entrepreneurs and investors, and may bring a significant increase in the amount of venture capital available for innovative start-ups. An entrepreneurial jurisdiction could reap the benefits by presenting a set of rules that are ideally suited to both start-up firms and venture capital funds.[25]

Indeed, the recent history of the reform of the private equity limited partnership, the standard organization form used by venture capitalists in the United States, the United Kingdom and continental Europe to supply finance to start-up firms,[26] suggests that governments have strong incentives to create efficient legal rules designed to meet the needs of these funds.

3. THE ORGANIZATIONAL AND LEGAL STRUCTURE OF VENTURE CAPITAL PARTNERSHIPS

This section turns to examine the source of funding which helps to address the basic concerns of venture capital investors, and provides a basis to survey the venture capital market. In the main, there are two types of venture capitalists: institutional venture capital funds and angel capitalists, who are wealthy individuals who make private equity investments in entrepreneurial firms.[27] Until recently, angel investors provided a significant amount of the financing to entrepreneurial

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[25] Three groups of players can be distinguished in the venture capital industry: outside investors, venture capital funds and entrepreneurs. Traditionally, the relationship between the first two players is managed and organized in a limited partnership. The venture capitalist is the general partner who will invest the limited partners' money in several rapidly growing and highly innovative businesses.

[26] See J. Lerner and A. Schoar, *The Illiquidity Puzzle: Theory and Evidence from Private Equity*, National Bureau of Economic Research (NBER) Working Paper 9146 (2002). In Europe, however, venture capital funds are often an affiliation to a corporate group. See A. Schwienbacher, *An Empirical Analysis of Venture Capital Exits in Europe and the United States*, Working Paper 2002, pp. 30-31.

[27] See P.A. Gompers and J. Lerner, *The Venture Capital Cycle* (Cambridge, The MIT Press 1999).

companies each year in the United States.[28] However, institutional venture capital funds have become the main funding source for entrepreneurial firms. There are four main types of venture capital funds: small business investment companies (SBICs), financial venture capital funds, corporate venture capital funds, and venture capital limited partnerships. In the United States, the limited partnership organizational form is the most popular type of venture capital fund. Even in the United Kingdom, where the limited partnership form under the Limited Partnership Act was seldom used, this form enjoys unusual prominence. There are a variety of reasons for this, such as tax benefits, the flexibility surrounding its structure and terms, and its fixed life. Individuals and institutions who invest in a limited partnership can delegate investment and monitoring decisions to the venture capitalists, who acts as the general partner.

The flexibility of the limited partnership form allows the internal and external participants to enter into covenants and schemes that align the incentives of venture capitalists with those of outside investors and reduce agency costs. For instance, limited partners are usually permitted, despite restrictions on their managerial rights, to vote on important issues such as amendments of the partnership agreement, dissolution of the partnership agreement, extension of the fund's life, removal of a general partner, and the valuation of the portfolio.[29] In addition, limited partners employ several restrictions when structuring the partnership agreement. In this respect, some have formulated two hypotheses:[30] (1) the costly contracting hypothesis and (2) the supply and demand hypothesis. The former predicts that a positive relationship exists between the use of restrictions and the propensity of the venture capitalist to behave opportunistically. Hence, in situations such as when the venture capitalist raise funds to invest in early stage ventures, the limited partner will use more restrictions to structure the partnership. Gompers and Lerner (1999) find in their sample of 140 partnership agreements, 14 distinct

[28] See A. Wong, *Angel Finance: the other venture Capitalist*, working paper (2002) (explaining that angel investors, which occupy a different segment of the market, employ a different level of institutional and control mechanisms than VCs).
[29] See Sahlman, *supra* footnote 11.
[30] See Gompers and Lerner, *supra* footnote 27.

covenants that address problems relating to the management of the fund, conflict of interests, and restrictions on the type of investment the fund can make. The number and type of covenants correspond to the uncertainty, information asymmetry and agency costs in the portfolio company. Other factors affecting the use of restrictions are the fund's size, the compensation system of the venture capitalist, and the reputation of the venture capitalist. The second hypothesis contends that relative supply and demand conditions in the venture capital market affects the covenants and restrictions in the long-term contracts. This hypothesis predicts that when demand for the services of well-established venture capitalists changes rapidly, while the supply of those venture capitalists is fixed in the short term, less restrictions should be observed in the partnership agreements. Accordingly, it can be inferred that financial contracts can assist to limit the use of contractual restrictions in the partnership agreement. Thus, limited partners use restrictive covenants to limit the value erosion caused by uncertainty and agency problems, because they are not able to take an active role in selecting and monitoring ventures.[31] However, contractual restrictions can lead to the erosion of value, as they limit the flexibility of the venture capitalist to diversify risk and deal with the agency problems in each venture. This puts extra pressure on the average return of the venture capital funds.[32]

The relationship between the limited partners and the general partners can be characterized as a principal-agent relationship, in which the principal is required to take precautionary measures to ensure that the agent will be less inclined to act opportunistically. The compensation of the venture capitalist is comprised of two main sources for managing investments in each limited partnership. First, venture capitalists are typically entitled to receive 20 per cent of the profits generated by each of the funds. A second source of compensation is the management fees the venture capitalists charge to each venture.[33] Thus seen, the flexibility

[31] See Sahlman, *supra* footnote 11.
[32] See P.A. Gompers and J. Lerner, 'Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations', 55 *Journal of Financial Economics* (2000).
[33] See Gompers and Lerner, *supra* footnote 27.

of the limited partnership plays a critical role in aligning the interests of venture capitalists and investors in limited partnerships.[34]

Despite several drawbacks, such as limited partnership shares not being publicly tradable and the archaic law governing this form,[35] the UK limited partnerships have become the standard structure used by European venture capitalists in general. That said, the UK's prominent position is under threat from other jurisdictions that have introduced or plan to design investor friendly legislation on limited partnerships. It is not surprising, therefore, that the Limited Partnership Act 1907 is currently under revision.[36] The threat of competition, combined with the lobbying efforts of venture capitalists and sophisticated investors will arguably make UK limited partnership law more sophisticated and suitable for venture capital investment. Consequently, the limited partnership law reform fits the UK government's objectives of creating modern business organization forms that support the needs of a competitive economy. For national policymakers a competitive economy means creating an innovative business environment suited to meet the needs of entrepreneurs and investors. The supply of appropriately designed business forms is an integral component of this strategy, which is increasingly being shaped by the forces of competition across Europe, which is discussed below.

4. REGULATORY COMPETITION IN EUROPE

This section discusses the effect of the competition among national rules on the evolution of corporate law rules. We consider moreover the incentives of states to respond quickly to the competition by adopting efficient legislation that meets business needs and assess whether the

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[34] See R.J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, John M. Olin Program in Law and Economics Working Paper 248, 2002.
[35] See P. Myners, *Institutional Investment in the UK: A Review*, 2001. p. 155 (arguing that English limited partnership law is particularly cumbersome because of strict constraints on the number of partners and on limited partners' involvement in investment advisory work).
[36] See section 5.

United Kingdom is likely to play a leading role in stimulating regulatory competition and experimentation in business statutes.

In an important sense, a competitive environment for business forms has yet to fully develop due to the *siège réel* doctrine that governs in most member states. In recent years, however, the combination of new decisions by the European Court of Justice (ECJ) and the legislative blockage in the EC's company law harmonization program has stimulated considerable interest in the competition between jurisdictions. While the real seat doctrine continues to restrict firm mobility, the ECJ's recent judgments in *Centros*, *Überseeing* and *Inspire Art* may,[37] in the near term, encourage the introduction of competitive lawmaking within the European Union. Member states may gain by competing to supply flexible business organization forms for closely held businesses. In fact, some of this sort of competition is stimulated by cross-border tax competition.[38] Consequently, there are adequate incentives for governments to create better business organization vehicles.

Thus, a crucial debate in Europe is whether a market for business forms will ultimately emerge within the European Union, and if so, whether it will be based on a Delaware-like model in which firms can freely select their country of incorporation.[39] In the face of mounting economic pressure to reduce existing levels of regulation, the virtual absence of any lawmaking behaviour that arguably resembles the charter competition in the United States suggests that there are substantive legal and procedural barriers to the establishment of jurisdictional competition

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[37] See *supra* footnote 12.

[38] W.J. Carney, 'The Political Economy of Competition for Corporate Charters', 26 *Journal of Legal Studies* (1997) p. 327; Code of Conduct Group, *Report form the Code of Conduct Group on Business Taxation to Ecofin Council*, 29 November 1999.

[39] See, e.g., W.F. Ebke, 'Centros – Some Realities and Some Mysteries', 48 *American Journal of Comparative Law* (2000). pp. 625-628 (explaining that competitive lawmaking has become a dominant theme in European company law); B.R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford, Clarendon Press 1997) pp. 421-451 (explaining the potential role of the market for incorporations in deepening European economic integration).

in the European Union.[40] Moreover, critics suggest that competition based on considerations of business forms will only play a marginal role in Europe. Firms (and their participants) that stand to decide where to organize their business would set a higher value on the tax rates they have to pay on capital income than on available business forms.[41] From the perspective of the jurisdictional competition paradigm, it is therefore more likely that innovative jurisdictions attempt to attract firms and capital by lowering their tax rates. Ireland and the Netherlands present famous cases of successfully capitalizing on the tax preferences of European and non-European business firms.[42]

There is also some evidence that in economies that are integrating, such as the European Union, competitive jurisdictions that have an excellent infrastructure, established customer and supplier bases, accumulated experience, and a well-trained workforce, bring about the clustering of industry, high-end services, and foreign investment. This clustering process creates forces that encourage spatial concentration, in that even more industry, services and capital will move to these countries.[43] In this view, the clusters allow an attractive country or

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[40] See F. Scharpf, *Governing in Europe, Effective and Democratic?* 9 (Oxford, Oxford University Press 1999) pp. 101-103.

[41] See E. Wymeersch, '*Centros*: A Landmark Decision in European Company Law', in Th. Baums, K.J. Hopt, and N. Horn, *Corporations, Capital Markets and Business in the Law*, Liber Amicorum Richard M. Buxbaum (London, Kluwer Law International 2000) (arguing that competition is taking place on the basis of differences in tax laws, labour laws and environmental laws in Europe; business forms are not an essential component of regulatory competition). Cf. E. Ferran, *Company Law Reform in the UK*, Working Paper (2001) (noting that limited evidence considered in the context of the UK's company law review supports the view that fiscal, operational and macro-economic considerations rather than business organization law are the major considerations in the decision whether or not to locate a business in a given country).

[42] See W.W. Bratton and J.A. McCahery, 'Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation', 38 *Common Market Law Review* (2001) p. 701.

[43] The spatial concentration is at the heart of the economic geography worldview (economic geography is the study of where economic activity takes place and why), which is underpinned by the 'new economic geography' synthesized by M. Fujita, P. Krugman and A.J. Venables, *The Spatial Economy, Cities, Regions, and International Trade* (Cambridge, The MIT Press 1999). See also N. Crafts and A.J. Venables, *Globalization in History: A Geographical Perspective,* Centre for Economic Policy

region to maintain its competitive position, even if it provides rigid and cumbersome business organization laws and higher tax rates.[44] Nevertheless, the ECJ decisions and the significant pent-up demand to organize a business by using a flexible business form may very well result in a competitive jurisdiction being on its guard against other jurisdictions trying to undermine its attractiveness.[45] This seems especially true in the period of the transition to internationalized production, which is characterized by an increasing mobility of capital service and industry. Under the influence of competitive market pressures, a number of member states are driven to institute reforms to their tax regimes and business forms not only to stem the flow of firms migrating to other countries, but also to gain a reputation for being a competitive jurisdiction which satisfies the needs of a range of firms. The incentive effect of regulatory competition is also present without firm mobility when firms can observe government performance across jurisdictions and can sanction political actors whose performance is inferior to that of other jurisdictions.[46] Furthermore, domestic lawyers

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Research (CEPR) Discussion Paper No. 3079 (2001) (arguing that the economic geography worldview is fundamental to understanding comparative economic development in the context of globalization). Examples abound of industrial clusters: Silicon Valley (a cluster of high-tech firms), German printing equipment, Italian ceramic tiles, Japanese robotics and American health care equipment.

[44] According to the *2001 Global Competitiveness Report* from the World Economic Forum, Finland is the most competitive economy in the world, despite its rigid labour markets, powerful unions and high tax rates. See M.E. Porter, J.D. Sachs. and J.W. McArthur, 'Executive Summary : Competitiveness and Stages of Economic Development', in *The Global Competitiveness Report 2001-2002*, World Economic Forum.

[45] Cf. R. Baldwin and P. Krugman, *Agglomeration, Integration and Tax Harmonization*, Centre for Economic Policy Research (CEPR) Discussion Paper No. 2630 (2000) (arguing that levying a extremely high tax rate could have catastrophic results for competitive countries; not only because capital will move abroad, but also because that movement will undermine the attractiveness of the particular jurisdiction in a massive and irreversible way).

[46] Cf. A. Breton and H. Ursprung, *Globalisation, Competitive Governments, and Constitutional Choice in Europe*, Center for Economic Studies & Ifo Institute for Economic Research (CESifo) Working Paper no. 657(2), (2002) p. 4. Thus seen, large firms that made irreversible investments and therefore cannot threaten to move their seat to another jurisdiction could conceivably join other interests in a lobbying process. See

who specialize in business formations have a high-powered incentive to lobby for competitive business organization laws, even if a jurisdiction has gained a reputation as an industrial cluster and a tax haven.

Indeed, recent developments in EU case law will set the stage for strong competition between jurisdictions in furnishing firms with optimal rules. Proponents submit that these recent cases permit firms to select the least costly legal system. In this view, firms can choose from among the number of member states offering more optimal regulations and more favourable conditions to long-term relational contracting.[47] The United Kingdom, which has signalled its commitment to regulatory responsiveness by offering varied and high-quality business organization laws, could be well-placed to establish itself as the leading state for European business formations, like Delaware in the United States. But charter fees and franchise taxes, which provide a high-powered incentive for Delaware to enter the competition for business forms, do not encourage the United Kingdom.[48] However, the United Kingdom could dominate firms' domicile choice as a side-effect of its aspiration to attract large volumes of business and risk capital. In fact, the language barrier that creates a real disadvantage for some jurisdictions may lead to many firms resolving their conflicts in the United Kingdom. Moreover, the United Kingdom has a substantial body of case law and a highly respected judiciary which could be an important advantage in this

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also W.W. Bratton and J.A. McCahery, 'The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World', 86 *Georgetown Law Journal* (1997) pp. 256-259 (discussing 'yardstick competition models' that attempt to ameliorate the Tiebout model's shortcomings by substituting the vote for mobility as the competitive mechanism).

[47] See, e.g., R.J. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function', 49 *American Journal of Comparative Law* (2001) p. 352 (arguing that *Centros* signals that venture capitalists and entrepreneurs will shop around for the most favourable jurisdiction that offers board control for the venture capitalists and exemption from employee participation rules).

[48] See Cheffins, *supra* footnote 39, pp. 435-440 (noting that from a tax perspective – the UK does not have franchise tax and charter fees – regulatory competition is largely irrelevant for the United Kingdom).

respect.[49] It also has a responsive legislature that may be motivated to develop amendments to its business organization law regime in response to demands in the marketplace. Another attractive feature that could have a considerable effect on attracting migrating firms is that UK business organization law is significantly more flexible vis-à-vis other European jurisdictions. Furthermore, the popularity of the United Kingdom for firms and financial intermediaries suggests that it is willing to offer legal rules that may be attractive for these firms. To the extent that the United Kingdom attracts a large number of new firms and is seen as a jurisdiction in which a firm might keep its headquarters, UK lawmakers arguably have incentives to promulgate legislation capable of attracting firms incorporated in other member states. Even though UK lawmakers lack a charter revenue motive to attract foreign firms, they will seek to provide legal rules that are attractive to firms' managers because British business lawyers and accountants will benefit from increased fee revenues. Unlike their counterparts in the United States, the British Bar associations have yet to step in to solve collective action problems regarding the drafting and enactment of beneficial legislation. Of course, UK lawyers and accountants will be even more willing to undertake the commitment to develop new business organization laws when they face competition from other states to retain in-state firms.[50] Yet, to the extent that British accountants have sufficient incentives to externalize costs, they have already mobilized to lobby lawmakers to enact legislation that meets their demands and preferences.[51]

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[49] See, e.g., B. Black, 'Is Corporate Law Trivial?: A Political and Economic Analysis', 84 *Northwestern University Law Review* (1990) (explaining that Delaware's competitive success is due to its specialized judiciary); R. Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle', 1 *Journal of Law, Economics and Organization* (1985) (explaining that businesses benefit from Delaware's well-developed precedent); Cheffins, *supra* footnote 39, p. 443 (suggesting that the UK's Chancery Division and a large stock of legal precedent could provide benefits for non-UK firms incorporating in Britain).

[50] Cf. L.A. Bebchuk and A. Cohen, *Firms' Decisions Where to Incorporate,* Working Paper (2002).

[51] See J.A. McCahery and E.P.M. Vermeulen, 'The Evolution of Closely Held Business Forms in Europe', 26 *Journal of Corporation Law* (2001).

Although it is likely that the United Kingdom holds the strongest card in the competition for business formations, other jurisdictions could also be encouraged to enter the market for business forms. In particular, smaller jurisdictions with sufficient resources may, supported by well-organized interest groups, decide to act entrepreneurially themselves. They may be motivated to help lift the curse on regulatory competition in Europe by actively attempting to maximize chartering revenues.[52] If the future shows that the most favourable jurisdiction dominates the domicile choice of firms, as envisaged in recent ECJ case law, increases in interest group pressure for competitive lawmaking can be expected. As noted earlier, small jurisdictions like Ireland or Luxembourg, would also be likely candidates to enter the competitive lawmaking environment for the supply of law as a product. As such, a leading state could reap the benefits by coming forward with a menu of business forms ideally suited to the preferences of closely held firms across the spectrum.[53] If such a jurisdiction were among the early group of movers to adopt competitive business forms, it could very well create a focal point, leading a significant number of domestic and foreign firms to select from a new generation of business forms. In turn, this could give such a country the lead in business formations. While the best available evidence indicates that the roadblocks to a market for competitive lawmaking within the European Union are substantial, it might be argued that smaller jurisdictions, highly exposed to the international market,

[52] The double taxation treaties most European countries have entered into act as a disincentive for jurisdictions to engage in regulatory competition. Cf. Cheffins (1997: 435). In addition, incorporation fees and franchise taxes are not easily obtainable in Europe after the ECJ case of *Ponente* (case 71/91 and 178/91 *Ponente Carni Spa* [1993] ECR 1947): 'duties paid by way of fees or dues (…) may be payment collected by way of consideration for transactions required by law in the public interest such as, for example, the registration of capital companies. The amount of such duties, which may vary according to the legal form taken by the company, must be calculated on the basis of the cost of the transaction, which may be assessed on a flat-rate basis.' See S.F.G. Rammeloo, *Corporations in Private International Law, A European Perspective* (Oxford, Oxford University Press 2001) pp. 18 and 271.

[53] Jurisdictions which already have a policy and reputation with respect to tax competition, may well have an incentive, supported by a number of organized interest groups, to take up regulatory competition in the context of business forms.

may have significant incentives to compete for inward investment by offering competitive business organization laws.

As Europe enters the competitive lawmaking environment, lawmakers will mainly focus on the needs of business firms that are most likely to engage in forum shopping. Since the Directives regarding publicly held corporations have reduced the feasibility of competition in the context of large corporations, European lawmakers will begin to turn their attention to 'closely held firms', such as large professional firms, venture capital funds, joint ventures and high-tech start-ups. Although jurisdictional competition in Europe is still in a developmental stage, the empirical evidence lends support to this view. We can already foresee a pattern of regulatory competition in the context of business organization law that prompts competitive lawmakers to innovate by initiating law reforms and introducing new legal entities that are better equipped than the traditional partnership and corporate forms to meet the changed needs of these firms.

It is important for responsive lawmakers to concentrate on the needs of firms in practice. Highly developed legislation for business firms at all levels signals that a jurisdiction is responsive to the demands of the business society. Furthermore, by having such a legal framework in place, jurisdictions mitigate the costs of statutory ambiguity and, hence, negative spill-over effects. From this perspective, introducing a separate limited partnership-form designed with the venture capital industry in mind is arguably necessary to prevent distortion of choice-of-business-form decisions and the resulting legal problems that arise when economic actors choose sub-optimal structures. This would allow choice of business forms to send a clearer signal about the parties' organizational needs. We now turn to examine recent efforts by UK lawmakers to introduce business forms tailored to the needs of a particular class of firms. It is suggested that the introduction of such a legal framework is crucial to stimulate the development of a robust venture capital environment in Europe.

5. LIMITED PARTNERSHIP LAW REFORM IN THE UNITED KINGDOM

Prompted by the threat of competition in combination with the lobbying efforts of, among others, venture capitalists and sophisticated investors, UK lawmakers recently published a report on partnership law reform in which they propose modern limited partnership legislation. The reform intends to abolish the rule on the maximum number of partners – presently limited to twenty – and introduce 'safe harbour' provisions, which, like those found in the Delaware Revised Uniform Limited Partnership Act and Jersey's limited partnership form, clearly establish that limited partners may participate in the control of the firm so as to improve certainty and accessibility to foreign investors.

Indeed, following the needs of commercial solicitors, UK lawmakers have proposed safe harbour provisions that offers guidance for limited partners, such as large institutional investors, concerning a list of activities in respect of his permissible involvement in a partnership. These include participation in (1) strategic decisions; (2) enforcement of rights; (3) approval of accounts of the limited partnership; (4) engagement in contractual work for the partnership; (5) acting as a director, employee or shareholder in a corporate general partner; (6) resolution of conflict of interest problems; and (7) consultation and advice.[54]

As for the entity-aggregate issue, UK lawmakers embrace the entity approach for the general and limited partnership form. They acknowledge that the legal entity status is a necessary shorthand device to define the property rights over with participants within a firm can contract.[55] However, given the importance of tax considerations in choosing a business form, the possible uncertainty about tax authorities' reaction to the introduction of bestowing partnerships with legal entity status, the UK lawmakers were forced to adopt a limited partnership

[54] See Schedule 6 of the UK Partnership Bill (The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003).
[55] H. Hansmann and R. Kraakman, 'The Essential Role of Organizational Law', 110 *Yale Law Journal* (2000).

without separate legal personality in order to circumvent cumbersome characterization issues. Given the need to attract more foreign investors, the special limited partnership without legal personality is obviously better able to preserve tax benefits overseas.[56]

Besides the preservation of tax transparency, legal clarity plays a pivotal role in private venture capital investments. The UK lawmakers rightly assume that the business parties involved in venture capital contracting create detailed legal agreements themselves.[57] As a consequence, in place of applying default rules of the General and Limited Partnership to the special vehicle, which has several spillover disadvantages, the lawmakers explicitly delink the special limited partnership from the other partnership forms.[58] By doing so, lawmakers recognize that default rules may impede the introduction of new contractual and financial incentive mechanisms. Moreover, the stickiness of default rule provisions may lead to uncertainty as to the enforceability of contractual modifications of the default rules.

Yet even if this vehicle represents a new policy direction in partnership law, it is unclear whether it creates a successful, low-cost solution for investors and venture capitalists alike. Although the UK lawmakers disapply most of the general and limited partnership default rules, the special limited partnership is still to some extent linked to the other partnership forms.[59] It is clear that the approach chosen by the UK

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[56] The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003, p. 27: 'Serious concerns have been expressed to us, particularly by the APP (Association of Partnership Practitioners), that giving legal personality to limited partnerships may affect their tax treatment overseas, and that uncertainty over that issue would affect their usefulness as a vehicle for investment and, therefore, be damaging to the economy.'

[57] Cf. Gilson, *supra* footnote 34.

[58] See Schedule 10 of the UK Partnership Bill (The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003).

[59] For an overview of the different forms of linkage between statutory forms, see L.E. Ribstein, 'Linking Statutory Forms', 58 *Law and Contemporary Problems* (1995). Besides the situation in which business form statutes are linked in the sense that rules from one statute are applied to a business form created under another statute, Ribstein distinguishes three other variations on linkage: (1) explicit linkage (one statute governs

lawmakers might lead to some uncertainty even though the contracting parties are professionals with significant bargaining power. Even though contract parties are willing to accept the challenge of drafting an agreement for the special limited partnership, transaction costs, information asymmetries and strategic behaviour could prevent them from bargaining their way to an optimal agreement. As a consequence, with respect to some operating formalities, such as fiduciary duties, the special limited partnership resembles a normal limited partnership.[60] In other respects, the special limited partnership constitutes a new partnership vehicle. In any event, the United Kingdom has clearly responded to the demands of a particular class of firms, such as investment funds, that possess the resources and capacity to draft comprehensive operational agreements that meet their special requirements.

[insert table here]

6. TOWARD A MORE EFFICIENT SPECIAL LIMITED PARTNERSHIP STATUTE

At first glance, this form of linkage of partnership vehicles within one statute has obvious benefits (e.g., clarity and simplicity). Note that linkage has the advantage that general partnerships can easily convert to the limited partnerships and vice versa without having to deal with the cumbersome formalities of changing to a completely new business form. Furthermore, special limited partnerships have access to the same

two business forms); (2) implicit linkage (a business form statute imports language from other business form statutes); (3) implicit delinkage (firms may waive certain provisions of a particular business form statute and so create a different business form).

[60] See The Law Commission and the Scottish Law Commission, Partnership Law, Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965, 2003, p. 300: ‘At the same time, our recommended reforms in relation to the overriding duty of good faith and the statutory statement of duties of disclosure on joining a partnership are as applicable to the special limited partnership as to any other partnership as are many default rules, for example, in relation to the sharing of profits and losses and the management of the business.

network and learning benefits as the other partnership forms. However, linking may also involve significant costs for business parties (e.g., distortions in the signalling function of business forms, erroneous gap-filling by courts and negative spill-over effects, and complications in contracting around fiduciary duties) that outweigh possible linking benefits.[61]

This is especially true for fiduciary duties. Indeed, even if parties could contract around fiduciary duties for their relationship, it is important that the role of fiduciary duties varies across business forms. Parties that want to remain unaffected by statutory fiduciary duties may, despite the default rule status of these duties, be reluctant to choose the special limited partnership. For instance, for the sake of fairness, courts may be inclined to impose fiduciary duties when disputes between the parties arise. Furthermore, given the stickiness of default rules, parties may be loath to contract around fiduciary duties. It is therefore argued that in venture capital fund limited partnerships the role of fiduciary duties should be limited.[62] First, the venture capital fund contracts deal with the monitoring and information asymmetry problems extensively. Second, the venture capitalists, as general partners, act as co-owners rather than 'fiduciaries on behalf of the limited partners'. Third, in the venture capital industry, extra-legal mechanisms, like reputation, often play a crucial role in preventing opportunism. In this respect, fiduciary duties could even hamper the functioning of the extra-legal mechanisms. Not only could the opportunistic use of these duties involve costly intra-relationship disputes and litigation, but, as noted, it could also increase the transaction costs of contracting around them.[63]

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[61] See Ribstein, *supra* footnote 59, pp. 203-206.

[62] See L.E. Ribstein, *Confining Fiduciary Duties*, Working Paper 2002; D. Rosenberg, 'Venture Capital Limited Partnerships: A Study in Freedom of Contract', *Columbia Business Law Review* (2002).

[63] Commentators note that explicit legal remedies crowd out the positive effect of extra-legal mechanisms. When parties have the explicit opportunity of bringing a remedial action against the opportunistic partner, they seem to rely more on the 'stick' and less on the 'carrot'. See, e.g., E. Fehr and S. Gächter, *Do Incentive Contracts Crowd Out Voluntary Cooperation?*, USC Center for Law, Economics & Organizational Research Paper No. C01-3, 2001.

The US Uniform Limited Partnership Act 2001 (ULPA 2001) deals partly with this problem by providing that a limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner.[64] As for the general partners the ULPA seems to follow the wording of the partnership act. However, for the reasons mentioned above, it is more efficient that a special limited partnership statute provides that the rights and duties of the parties will be specified in their agreement.[65]

The UK's special limited partnership has yet another flaw in its design. As we have seen,[66] changing economic conditions often entail the need for new contractual regimes, which enlarge the control of the limited partners over the venture.[67] As a consequence, a special limited partnership form which offers a staggering degree of freedom to design the relationship between the investors and the venture capitalists seems necessary to facilitate negotiations and renegotiations without being held back by restricted rules.[68] In this view, the list in Schedule 6 of the UK

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[64] See ULPA 2001 §305.

[65] In order to clarify the range of fiduciary duties in special limited partnerships, UK lawmakers could alternatively adopt a provision similar to section 17-1101 of the Delaware Limited Partnership Act, which states that '(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements. (d) To the extent that, at law or in equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or another partner, (1) any such partner acting under a partnership agreement shall not be liable to the limited partnership or to any such other partner for the partner's good faith reliance on the provisions of such partnership agreement, and (2) the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement.' It appears that the popularity of Delaware's limited partnership is largely due to the flexibility given by this provision. See *Kahn* v. *Icahn*, No. CIV.A.15916, 1998 WL 832629 (Del. Ch. Sept. 10, 1998).

[66] See Section 3.

[67] Cf. Ch. J. Goetz and R.E. Scott, 'The Limites of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms', 73 *California Law Review* (1985) p. 296.

[68] Cf. M.D. Goldman and E.M. Filliben, 'Corporate Governance: Current Trends and Likely Developments for the Twenty-First Century', 25 *Delaware Journal of Corporate Law* (2000).

Partnership Bill could be too limited in range.[69] For the special limited partnership an extensive control rule may be more attractive to foreign, especially US, investors. For instance, Delaware's extensive safe harbour provisions allow limited partners' intervention to a much larger extent, but doesn't offer a full protection since the rule still inhibits several limited partner actions. If a limited partner in a Delaware limited partnership participates in the control of the business, he is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.[70]

In the laboratory of regulatory competition, the pressure on the mandatory obligation to have one or more general partners that are, by definition, unlimitedly liable for the debts and obligations of the firm is increasing. From a relatively early date, legal practitioners solved the problem of general partners' unlimited liability by creating a hybrid business form between the limited partnership and a corporation, which played the role of a general partner. However, despite the popularity of the limited partnership with a corporate partner, it is not always efficient to use this hybrid form. Besides the fact that it is not recognized or is prohibited from engaging in specific kinds of activities in some countries, the limited partnership with a corporation as the sole shareholder is an incomplete response, because this vehicle comprises two business entities that must be organized and administered separately. For this reason the ULPA 2001 permits limited liability limited partnership election which protects general partners against claims arising from the firm's obligations and debts.

Finally, a limited partnership with shares, in which the general partners have exclusive management control and the limited partners may transfer their shares freely, appears to respond to the pent-up

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[69] In order to have some flexibility, the UK lawmakers propose that the Secretary of State may by order amend Schedule 6 (by adding, modifying or omitting an activity).

[70] See section 17-303 of the Delaware Limited Partnership Act. ULPA 2001 provides that a limited partner is not personally liable, even if the limited partner participates in the management and control of the limited partnership (ULPA 2001 §303). This approach, however, is wrong headed since it disregards the importance of the governance structure of the limited partnership for venture capital funds.

demand for more easily tradable private investments. As interest in venture capital funds already change hands increasingly in the secondary market, the conversion to a combination of a limited partnership and public corporation, which offers ready access to liquidity and market price, could be a viable alternative. However, several EU Directives apply to the limited partnerships with a share capital, which makes implementation cumbersome. The special limited partnership provisions should nevertheless explicitly allow for the transferability of the limited partners' interest. In order to be competitive, legal and fiscal complications regarding the transfer of interests should be minimized. For instance, the administrative burden of officially registering the name of each limited partner and the amount of any relevant capital contribution made by the limited partners should be omitted.[71]

7. CONCLUSION

This article explored the dynamic of regulatory competition on the change in the structure of legal business forms. The analysis focused on the economic importance of the limited partnership form's features for the creation of a robust venture capital market. It was shown that the introduction of a modern limited partnership form, which features the protection of the limited partners and is limited partner-friendly, promises to benefit the venture capital industry in Europe.

We have suggested that the advent of competitive pressures regarding law reforms has created some incentives for national lawmakers to generate new statutory measures. It identified the recent introduction of the special limited partnership form in the United Kingdom--in order to

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[71] See clause 66 and 68 in conjunction with Schedule 7 of the UK Partnership Bill. Form a historical point of view, the Law Commission's recommendation to consider registration as a prerequisite for limited liability is misguided. The mediaeval limited partnership, the *commenda*, offered investors limited liability and anonymity. By doing so, this business form made it possible for special interest groups, such as the nobles and the clergy, to pour money into lucrative ventures without risking being condemned for usury or violating inhibitions against engaging in trade. See, e.g., J.W. Callison, *Partnership Law and Practice, General and Limited Partnerships* (St. Paul, West Group 2001).

stem the outflow of venture capital funds and investment vehicles to other jurisdictions—as a prime instance of competitive lawmaking in Europe. Our doctrinal analysis of the UK special limited partnership statute shows that lawmakers have responded to the competitive dynamic by supplying features that are valued by investment firms. Even though the special limited partnership statute offers a competitive business form for venture capital funds, we identify some reasons why the legislation in some respects does not fully meet the needs of investors. Accordingly, the analysis here offers a number of recommendations to address the problems identified in the legislation.